

# CAPITAL REVENUE FORECAST

## MAJOR CAPITAL REVENUES

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The major revenues that support the City of San José's capital programs are bond proceeds, grants, transfers between funds, and a number of taxes levied on construction and property resale (conveyance) activity. This document provides a five-year forecast for the following taxes and fees: Construction and Conveyance Tax; Building and Structure Construction Tax; Construction Excise Tax; Residential Construction Tax; Sanitary Sewer Connection Fee; and the Storm Drainage Connection Fee.

As shown below, these revenues are expected to generate \$258.4 million over the next five years, an increase of 4% over the 2007-2011 Adopted Capital Improvement Program (CIP) estimates. The Construction-Related Revenue chart included at the end of this section provides a year-by-year comparison of this forecast with 2007-2011 Adopted CIP.

### Forecast Comparison Summary

(\$ in Thousands)

	2007-2011 CIP	2008-2012 Forecast	Difference	Change
Construction and Conveyance Tax	119,000	127,000	8,000	7%
Building and Structure Construction Tax	49,952	50,167	215	0%
Construction Excise Tax	69,928	72,203	2,275	3%
Residential Construction Tax	1,214	1,124	(90)	(7%)
Sanitary Sewer Connection Fee	5,654	6,305	651	12%
Storm Drainage Connection Fee	2,624	1,565	(1,059)	(40%)
<b>TOTAL</b>	<b>248,372</b>	<b>258,364</b>	<b>9,992</b>	<b>4%</b>

For the Construction and Conveyance Tax, the Conveyance Tax portion (property transfers) account for 98% of the total collections. The fall off from the number of real estate transactions that began in February 2006, as predicted in the development of the 2007-2011 Forecast and after experiencing years of double-digit growth, has continued through the first part of 2006-2007. Though the rate of decline has slowed, January 2007 represented the ninth consecutive month of declining Construction and Conveyance Tax collections suggesting these revenues may not have yet reached bottom. Even with this decline, receipts are still expected to normalize at a slightly higher annual collection level than previously forecasted. As a result, this category is expected to generate \$127 million over the next five-years, an increase of \$8 million over the estimates assumed in the 2007-2011 Adopted Capital Improvement Program (CIP). The average annual collection level of \$25.4 million in the 2008-2012 Forecast, however, is well below the actual collection levels in recent years that reached a peak of \$49 million in 2005-2006 and the \$34 million anticipated for 2006-2007.

The capital revenue projections for the other taxes and fees described in this forecast are derived from construction activity estimates provided by the Planning, Building and Code Enforcement Department. Each year the Planning, Building, and Code Enforcement Department provides

**MAJOR CAPITAL REVENUES (CONT'D.)**

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## CAPITAL REVENUE FORECAST

projections of activity for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. A more complete discussion of these estimates is provided in a technical report prepared by that department entitled “Development Activity Highlights and Five-Year Forecast (2007-2012)”, which is attached as an appendix to this document.

Over the forecast period, construction activity is expected to remain relatively flat with valuation hovering around \$1 billion in each of the next five years. These assumptions are consistent with those presented in the 2007-2011 Forecast. Construction activity peaked in 2000-2001 at \$1.9 billion, followed by a sharp decline that reached a low point of \$766 million in 2003-2004. From that low point, a modest recovery occurred in 2004-2005 with growth of 14% in that year. However, in 2005-2006, construction activity dipped to \$774 million, primarily due to a fall off of multi-family development to a ten-year low. A modest rebound, especially in the downtown area, is anticipated in 2006-2007 and 2007-2008, with a slight decrease in activity expected in each year from 2008-2009 through 2009-2010. In 2010-2011 and 2011-2012, activity is expected to increase modestly to levels assumed in 2007-2008. Based on the construction activity estimates and a review of revenue collection patterns, only a slight increase in construction-related taxes and fees of \$2 million, or 1.5%, is expected when comparing the 2008-2012 Forecast to the 2007-2011 Adopted CIP estimates.

Each of the six revenue categories along with a discussion of the major construction activity trends are discussed in more detail below.

### CONSTRUCTION AND CONVEYANCE TAX

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The Construction Tax portion of the Construction and Conveyance Tax category is levied on most types of construction. For residential construction, the tax rate is based upon the number of units constructed and ranges from \$75 per unit located in a building containing at least twenty dwelling units to \$150 for a single-family residence. The commercial and industrial rate is eight cents per square foot of floor area constructed. The Construction Tax accounts for approximately 2% of the total Construction and Conveyance Taxes collected.

The Conveyance Tax portion of the Construction and Conveyance Tax category is imposed upon each transfer of real property where the value of the property exceeds one hundred dollars. The tax is imposed at a rate of \$1.65 for each \$500 of the value of the property. The Conveyance Tax accounts for approximately 98% of the total Construction and Conveyance Taxes collected.

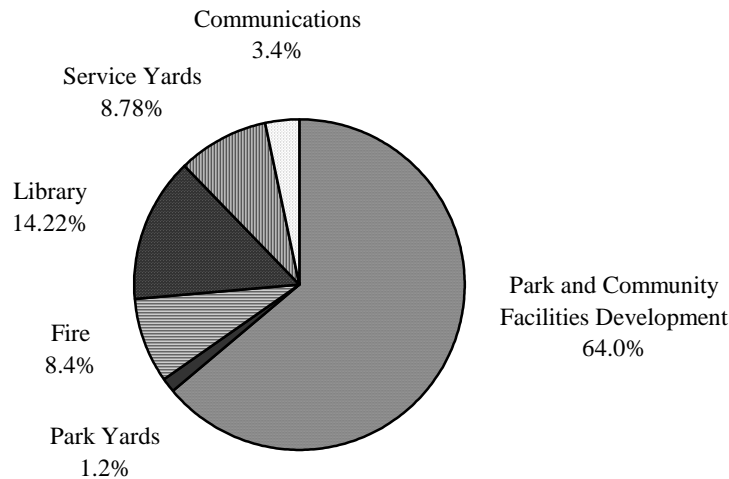
Construction and Conveyance Tax receipts are allocated using the following distribution to capital programs.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

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### Construction and Conveyance Tax Distribution



The combined proceeds from the Construction and Conveyance Tax may be used for facility acquisition, construction, equipment, furnishings, and limited operating and maintenance expenses.

Consistent with the Construction and Conveyance Tax Task Force recommendations adopted by the City Council in June 1989, the Park and Community Facilities Development portion of the estimated revenues, less non-construction costs and transfers to the General Fund, is allocated for all years of the forecast using a two-to-one ratio, with two-thirds of the proceeds going to neighborhood/district projects and one-third to city-wide projects. Per the current City Council policy, 20% of funds for neighborhood/district projects is set aside and equally allocated to meet special needs. The balance of the funds is then distributed based on a formula using the following criteria:

- neighborhood and community-serving park acres per 1,000 population;
- developed neighborhood and community-serving park acres per 1,000 population;
- square feet of neighborhood and community-serving center space per 1,000 population; and
- developed park acres and/or facilities in good condition per 1,000 population.

The five-year projection for Construction and Conveyance Tax revenue totals \$127 million, an increase of \$8 million from the \$119 million estimated in the 2007-2011 CIP. The Construction and Conveyance Tax revenue projections are based upon: 1) a review of prior year collection trends; 2) a review of year-to-date residential sales activity in San José; 3) a review of year-to-date tax receipts; and 4) projections of the future strength of the San José real estate market.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

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- **Prior Year Collection Trends**

Historically, Construction and Conveyance Tax revenues have been very volatile, reflecting the impacts of the ups and downs of the local economy. In the late 1980's, collections in this area were relatively strong, peaking at \$18 million in 1988-1989. In the first half of the 1990's, however, revenue fell precipitously with collections ranging from approximately \$9.3 million to \$11 million annually, reflecting the economic slowdown experienced at that time. In the latter half of the 1990's, healthy annual increases were again realized in this revenue category with growth skyrocketing from \$13.4 million in 1995-1996 to a peak of \$31.6 million in 2000-2001. This tremendous growth was indicative of the economic gains during that period, marked by stock market growth, low unemployment, and gains in personal income. As economic conditions began to worsen, tax receipts in this area fell, experiencing a 17% decline in 2001-2002 to \$26.3 million and an additional 5.5% decline in 2002-2003 to \$24.8 million. Surprisingly, however, and contrary to our projections, this drop-off did not continue, even though the general economic conditions did not improve significantly. Far exceeding our projections, collections grew to \$38.2 million in 2003-2004 and reached a record setting high of \$49 million in 2005-2006.

- **2006-2007 Collections**

As experienced toward the last half of 2005-2006 and forecasted in the 2007-2011 Forecast, the local real estate market has finally experienced a slowdown after years of record setting activity. Collections received in January 2007 represented the ninth consecutive month of declining revenues compared to the same month in the prior year. Construction and Conveyance Tax collections in 2006-2007 of \$21.5 million through January 2007, represents a decrease of approximately 29% from the prior year. A number of indicators suggest these revenues may not have yet reached bottom. The number of property transfers for all types of residences has decreased by 8.6% through January 2007 when compared to the same period last fiscal year. The average days on market has steadily grown from 45 days in January 2006 to 67 days in January 2007. The median single-family home price of \$697,000 in January 2007 reflects only a 2% growth compared to the \$683,000 figure in January 2006.

Despite the slowdown in the real estate market, it is still anticipated that Construction and Conveyance Tax receipts will end the year at \$34 million. This figure is above the \$27 million adopted in the current CIP, however, which assumed an approximate decline of 45% from the collection level of \$49 million received in 2005-2006.

# CAPITAL REVENUE FORECAST

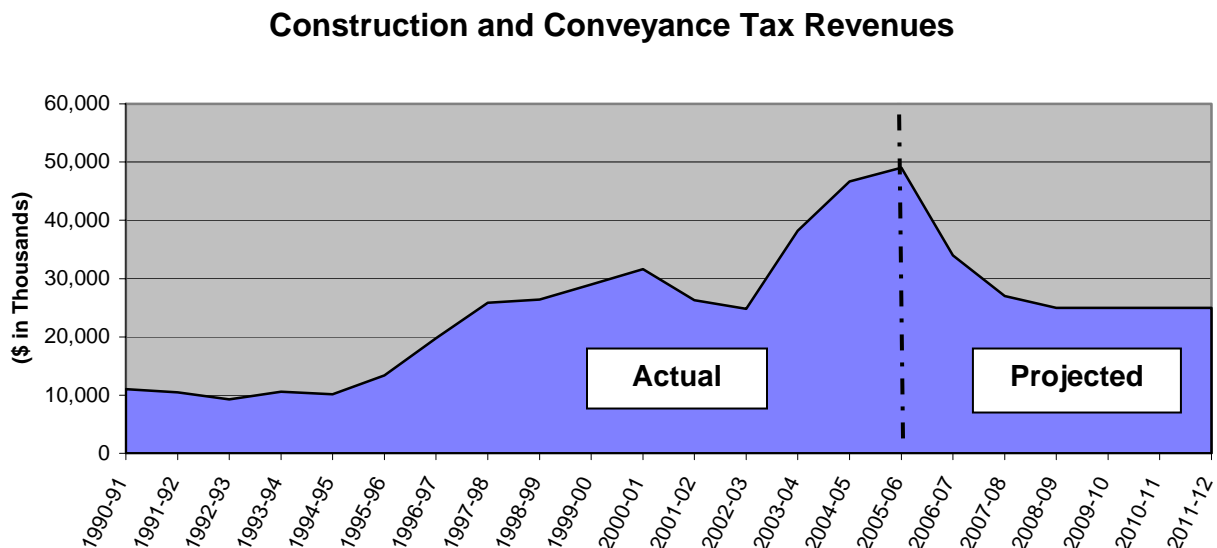
## CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

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- **2008-2012 Collections**

The 2008-2012 Construction and Conveyance Tax revenue forecast is built on the assumption that collections will continue to reflect a softening real estate market, with collections falling to \$27 million in 2007-2008 and leveling off at \$25 million annually for each of the remaining years of the forecast. This forecasted collection level reflects what is believed to be a more sustainable level of ongoing housing resale activity.

The following graph illustrates the actual and projected revenues for the combined Construction and Conveyance Tax revenues:



## CONSTRUCTION ACTIVITY PROJECTIONS

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With the exception of the Construction and Conveyance Tax Fund, the capital revenues described in this forecast are construction-related taxes and fees. As described above, the Planning, Building and Code Enforcement Department has provided construction activity projections for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. These construction activity estimates are described in the technical report prepared by that department entitled “Development Activity Highlights and Five-Year Forecast (2007-2012)”, which is attached as an appendix to this document.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

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A summary of the Planning, Building and Code Enforcement Department construction activity projections and the corresponding revenue estimates are provided below. Due to the highly volatile nature of the construction and real estate markets, the reliability of the estimates can be expected to decline over the period of the forecast. As a result, for the final two years, the Planning, Building and Code Enforcement Department has held its projections constant. The Department intends these to be interpreted as “ball park” estimates of the most likely state of the local economy based on current information. As new information becomes available, these estimates will be refined. The Budget Office actively monitors changes in development activity and reports this information to the City Council through Monthly Financial Reports.

### A. Residential Construction Activity

A significant portion of development-related revenue in San José has traditionally been generated by residential construction. Permit activity in 2005-2006 was relatively light, with building permits issued for 2,515 new dwelling units, in part due to low multi-family construction activity. This represented a five-year low with an overall decrease of 24% from 3,293 units issued in 2004-2005. In 2006-2007, the issuance of permits is expected to experience a recovery, with an estimated 3,000 new units.

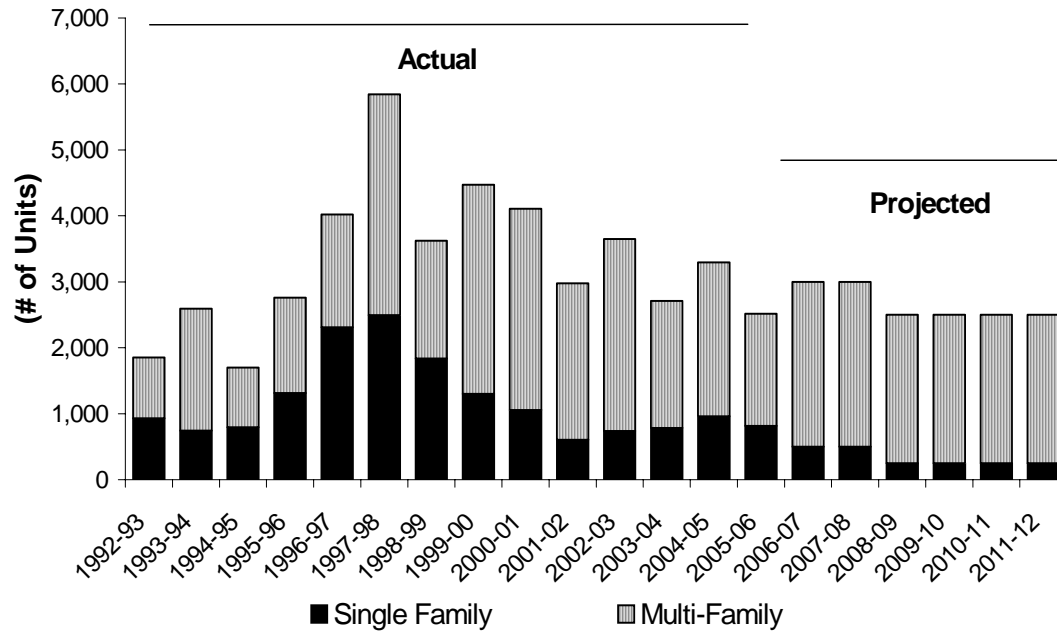
Residential construction activity is expected to generate 13,000 units over the five-year period, an average of 2,600 units per year. This activity level represents a slight decrease compared to the 2,700 units per year estimate included in the 2007-2011 Forecast and 2006-2010 Forecast. This activity level, however, represents a significant decline from the actual levels experienced in recent years, which reached a high of 5,842 units in 1997-1998.

Reflecting a trend of high-rise housing in downtown and North San José, a total of 11,500 multi-family units are expected to be constructed over the next five years, an increase from the 9,250 multi-family units projected in the 2005-2009, 2006-2010, and 2007-2011 Forecasts. In this Forecast, only 1,500 single-family dwellings are anticipated. This figure is a significant decrease from the 4,250 anticipated in the 2006-2010 and 2007-2011 Forecasts and well below the 4,000 units included in the 2004-2008 and 2005-2009 Forecasts and the 3,500 units included in the 2003-2007 Forecast. The following chart shows the number of units, by housing type, anticipated in San José through 2011-2012.

# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

### Residential Construction Activity



### B. Commercial Construction Activity

In 2005-2006, commercial construction activity totaled \$205 million, a slight decrease from the 2004-2005 level of \$214 million but a huge drop (73%) from the peak reached in 2000-2001 of \$765 million. Planning staff expects commercial activity to experience moderate increases in 2006-2007, with permit valuation estimated to reach \$275 million.

Over the forecast period, commercial construction is expected to rebound somewhat with anticipated valuations of \$325 million through the five-year period represented in the forecast (see the chart in section C below). The total commercial valuation projected in this forecast is \$1.6 billion, which is only slightly below the \$1.7 billion estimated in the previous five-year forecast. As discussed in the attached report provided by the Planning, Building and Code Enforcement Department, the outlook for commercial construction activity is moderate with pending applications for a major expansion of the Valley Fair Shopping Center, and expected development in the downtown and North San José areas in support of the new housing growth in those areas. This trend is further evidenced by the pending Whole Foods Market project immediately adjacent to residential development along The Alameda.

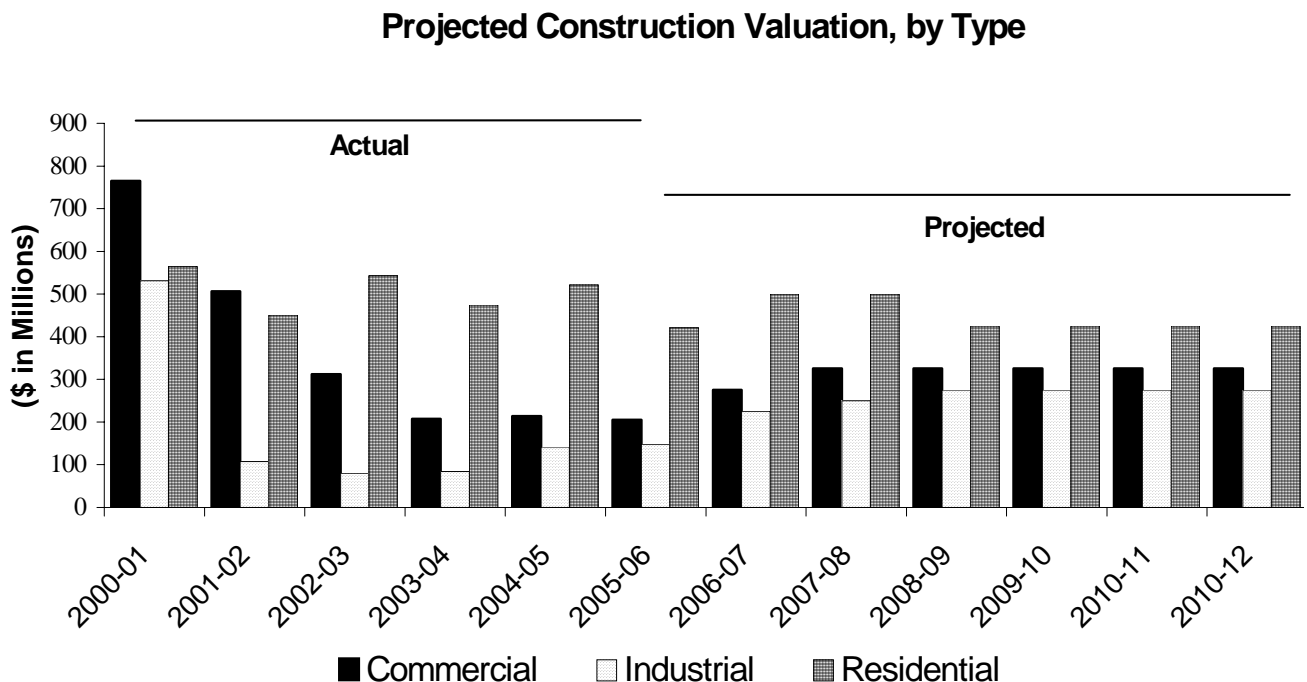
# CAPITAL REVENUE FORECAST

## CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

### C. Industrial Construction Activity

Industrial construction activity has experienced a dramatic decline since the peak in 2000-2001. In 2002-2003, permit valuation reached a low point of only \$80 million, far below the peak of \$531 million in 2000-2001. In 2004-2005, a slight recovery was experienced with permit valuation reaching \$142 million, with modest permit valuation growth to \$148 million in 2005-2006. Modest improvement is expected to continue through the forecast period, with permit valuation projected to reach \$225 million in 2006-2007, increase to \$250 million in 2007-2008, and \$275 million for the remaining years of the Forecast. The total industrial valuation over the forecast is estimated at \$1.35 billion, which is slightly below the \$1.48 billion estimated in the last forecast. As discussed in the attached report provided by the Planning, Building, and Code Enforcement Department, activity in this area is expected to remain slow with no significant new supply over the forecast period. However, recent job growth and strong corporate profit trends suggest a modest economic turnaround may be underway. This is exemplified by the recent groundbreaking of a building at Cadence Design Systems and the purchase of property by Adobe Systems near their existing downtown headquarters.

The following graph illustrates the level of projected construction activity by type (not including exemptions).





# CAPITAL REVENUE FORECAST

## MAJOR DEVELOPMENT ACTIVITY DATA

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As part of the attached Development Activity Highlights and Five-Year Forecast (2007-2012) document prepared by the Planning, Building and Code Enforcement Department, information is provided on development activity that serves as the foundation for their forecast. Data is provided on the major projects (residential projects greater than 50 units, commercial projects greater than 25,000 square feet, and industrial projects greater than 75,000 square feet) and is broken down by the three major land use categories – residential, commercial, and industrial. The projects are further subdivided into four categories based on their status (completed, under construction, approved but not yet commenced, and pending City approval). In addition, individual maps are provided for each of the 15 planning areas in the City that show the projects in all status categories submitted since January 1, 2003. These maps can be used in conjunction with the activity data to help analyze the rate, type and location of major development activity in San José.

## BUILDING AND STRUCTURE CONSTRUCTION TAX

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The Building and Structure Construction Tax is imposed upon the construction, repair or improvement of any building or structure where a building permit is required. Current rates are:

- 1) Residential -  $1\frac{3}{4}\%$  of 88% of the Building Official's valuation.
- 2) Commercial -  $1\frac{1}{2}\%$  of the Building Official's valuation.
- 3) Industrial - 1% of the Building Official's valuation.

The proceeds from the Building and Structure Construction Tax are restricted by ordinance for use for traffic capital improvements on major arterials and collectors. These improvements can include the acquisition of land and interest in land and the construction, reconstruction, replacement, widening, modification and alteration (but not maintenance) of City streets. This tax revenue provides the Traffic Capital program with funds to complete major street infrastructure projects, particularly those that improve the Level of Service (LOS). LOS refers to the efficiency with which streets and roadways accommodate peak level traffic.

Based on the construction activity forecasts supplied by the Planning, Building and Code Enforcement Department and an analysis of actual collection patterns, the five-year projection for the Building and Structure Construction Tax collections totals \$50.2 million, with annual proceeds ranging from \$10.0 million to \$10.3 million. The five-year revenue figure represents a slight increase of approximately \$215,000 (0.4%) from the estimate included in the 2007-2011 Adopted CIP. While collections are expected to improve slightly over the forecast period, the projected activity levels are still well below the peak. For instance, the 2007-2008 revenue estimate of \$10.3 million is a drop of over 40% from the actual receipts in 2000-2001 of \$17.4 million.

A comparison of the five-year forecast with actual collections in previous years is shown in the chart in the following section.

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## CONSTRUCTION EXCISE TAX

The Construction Excise Tax (also referred to as the Commercial-Residential-Mobile Home Park Building Tax) is imposed upon the construction, alteration, repair or improvement of any building or structure, which is for residential or commercial purposes or is associated with a mobile home. This general purpose tax may be used for any “usual current expenses” of the City. However, the City Council has historically used the majority of these funds for traffic improvements. The current rates are:

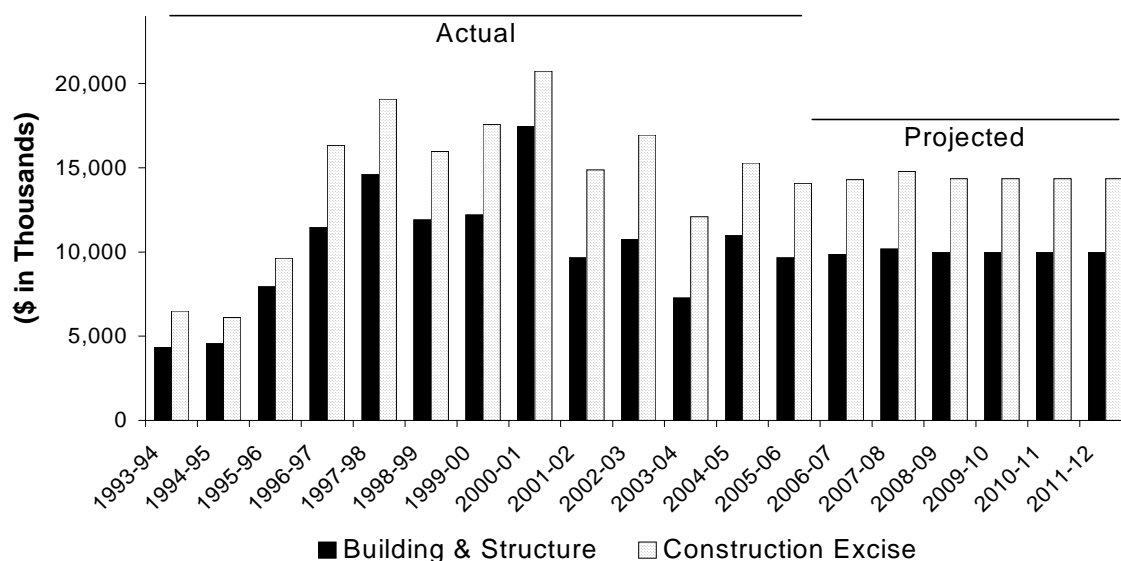
- 1) Residential - 2 <sup>3</sup>/<sub>4</sub>% of 88% of the Building Official’s valuation.
- 2) Commercial - 3% of the Building Official's valuation.

Unlike the Building and Structure Construction Tax, this tax does not apply to industrial development. As a result, changes in industrial building activity do not affect these tax receipts.

This tax is a general fund tax that can be used for any purpose. The majority of the proceeds have generally been used for a variety of essential Traffic Capital projects that cannot be funded by the Building and Structure Construction Tax or grants. Typical projects funded with this tax include street maintenance and resurfacing, streetlights, bicycle and pedestrian facilities, and most strategic planning programs, which improve the City’s ability to obtain State and federal grants. A portion of these taxes have also been regularly used to help balance General Fund problems during times of financial stress on that fund.

Based upon the construction projections provided by the Planning, Building and Code Enforcement Department, Construction Excise Tax collections are projected to total \$72.2 million over the five-year forecast period. This collection level represents an increase of \$2.3 million (3.3%) from the 2007-2011 Adopted CIP. This increase reflects the assumptions that residential and commercial construction activity is expected to remain stable over the forecast period.

### Major Construction-Related Tax Revenues



# **CAPITAL REVENUE FORECAST**

## **RESIDENTIAL CONSTRUCTION TAX**

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The Residential Construction Tax is imposed upon the construction of residential dwelling units and mobile home lots in the City. The rates are imposed on each dwelling unit and differ according to the number of units located in the building. Rates vary from \$90 for each dwelling unit in a multiple dwelling of at least twenty units to \$180 for a single-family residence.

This tax is collected and placed in the Residential Construction Tax Contribution Fund and is used to reimburse developers that have constructed a wider arterial street than their residential development required. The funds are also used to construct median island landscaping and other street improvements.

Based upon construction estimates by the Planning, Building and Code Enforcement Department and the actual collection pattern for this tax, \$1.1 million in revenue is expected over the five-year period of this forecast. This amount is slightly below the 2007-2011 Adopted CIP revenue estimates of \$1.2 million.

## **SANITARY SEWER CONNECTION FEE**

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The Sanitary Sewer Connection Fee is charged for connecting to the City's sewer system. The fees collected may only be used for the construction and reconstruction, including land acquisition, of the San José sanitary sewer system. The fee is based on the number of single and multi-family residential units built and the acres developed on commercial and industrial properties.

The 2008-2012 projection for this fee is \$6.6 million, which is an 11.5% overall increase from the 2007-2011 CIP estimate of \$5.7 million. Collections are expected to remain stable over the forecast period. In addition to being affected by the lack of a significant rebound in development activity, this category is impacted by a drop in the amount of projects involving undeveloped parcels for which these fees are assessed. Property that is being redeveloped typically is not subject to the fee.

## **STORM DRAINAGE CONNECTION FEE**

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The Storm Drainage Connection Fee is charged to the owner of any land that discharges storm water, surface water or ground water runoff into the City's storm drainage system. The fees are charged by acreage or lot and vary by land use and by the number of units located in the development. Storm Drainage Connection Fees may only be used for the construction, reconstruction, land acquisition and maintenance of the San José storm drainage system. The five-year forecast for Storm Drainage Connection Fees is \$1.6 million, which is a decrease from the estimate of \$2.6 million included in the 2007-2011 CIP. The impact of in-fill developments, which are not subject to this fee, continues to affect fee collections. Over the five-year forecast period these fees are projected at approximately \$0.3 million annually.

# CAPITAL REVENUE FORECAST

## STORM DRAINAGE CONNECTION FEE (CONT'D.)

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